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Section 4941 -- Excise Taxes on Acts of Self-Dealing
4941.00-00 Excise Taxes on Acts of Self-Dealing

Section 664 -- Charitable Remainder Trusts
664.00-00 Charitable Remainder Trusts

664.03-00 Definitions

664.03-02 Charitable Remainder Unitrust

LEGEND:

Trust =

Settlors =

N Charity =

Dear

This is in reply to Trust's request dated July 28, 2009 for a ruling that the proposed judicial reformation will not constitute an act of self-dealing as defined in section 4941 of the Internal Revenue Code ("Code").

FACTS:

Trust was established by Settlers, who are husband and wife. By its terms, Trust is an irrevocable net income with makeup charitable remainder unitrust ("NIMCRUT"). As originally executed, Trust provides that in each taxable year of the Trust, the Trustees shall pay the unitrust amount to Settlers. After the death of the first Settlor, the unitrust amount is to be paid to the surviving Settlor until death. Trust defines the unitrust amount as (1) the lesser of (i) the Trust income for the taxable year (as defined in Section 643(b)) and (ii) eight percent (8%) of the net fair market value of the trust assets, valued as of the first day of each taxable year of the trust, plus (2) any amount of income of the Trust that is in excess of eight percent (8%) for such taxable year, but only to the extent that the aggregate of the unitrust amounts paid in prior taxable years was less than the aggregate eight percent (8%) determined for all such prior taxable years (the "NIMCRUT provisions").

Trust provides that upon termination of the non-charitable interests, the then trustees shall distribute all of the remaining principal and income to such charitable beneficiary or beneficiaries, as may have been designated in writing by Settlers (or the survivor of them), each of which then qualifies as an organization described in Section 170 of the Code, and for which a deduction is allowed for estate and/or gift tax purposes under Sections 2055 and 2522, as the case may be, and other applicable provisions of the Code. In default of such a designation by Settlers or subject to any partial designation, the principal shall be paid to the N Charity, or if it is not then in existence or does not qualify under the above tax provisions, to such similar organization(s) as the then trustees may determine in their sole discretion.

Settlers wanted, and thought they had executed, a Trust in which the NIMCRUT provisions were applicable so long as Trust held certain specified contributed property. If the property was sold then the Settlers wanted the Trust to then convert to a charitable remainder trust ("CRUT"). To correct the scrivener's error, the Trustees filed a petition with the appropriate state court requesting a reformation of the Trust. The requested reformation provided that once certain contributed property was sold by the Trust, the unitrust amount during the remaining unitrust period shall be an amount equal to eight percent (8%) of the net fair market value of the Trust assets, valued as of the first day of each taxable year of the Trust. The state court granted the request to reform the Trust, converting the NIMCRUT provisions to an amount based solely on the value of Trust assets on the date on which certain assets contributed to Trust were sold. The court's order provides that the reformation will be effective on the date when the Internal Revenue Service approves such reformation.

Settlers have submitted affidavits stating that when they executed the Trust, they intended and believed that the trust should be drafted so that in the beginning it would be a NIMCRUT and that upon the sale of certain Trust property, the Trust would convert into a CRUT in the taxable year after the year in which the Trust property was sold. Settlers have also represented that from the inception of the Trust until the present day, no deduction has been allowed for any income interest that either Settlor has received or been entitled to receive under Sections 170, 2055, or 2522 of the Code. Also, notes in the handwriting of the drafting attorney, who is now incapacitated, indicate that the Trust was supposed to be a CRUT instead of a NIMCRUT after the property was sold. In addition, all parties to the Trust, including the charitable beneficiary have consented in writing to the reformation of the Trust.

RULINGS REQUESTED:

1. Whether the October 1, 2008, judicial reformation of and amendment to the Trust, ab initio, violate Section 664 of the Code and the reformed and amended Trust continues to qualify as a charitable remainder unitrust under Section 664.
2. Whether a proposed judicial reformation of the Trust will be an act of self-dealing under section 4941 of the Code

LAW:

Issue 1:

Section 664(d)(2) of the Code provides that for purposes of Section 664, a charitable remainder unitrust is a trust — (A) from which a fixed percentage (which is not less than 5 percent nor more than 50 percent of the initial net fair market value of all property placed in trust) is to be paid, not less frequently than annually, to one or more persons (at least one of which is not an organization described in Section 170(c) and, in the case of individuals, only to an individual who is living at the time of creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals; (B) from which no amount other than the payments described in Section 664(d)(2)(A) and other than qualified gratuitous transfers described in Section 664(d)(2)(C) may be paid to or for the use of any person other than an organization described in Section 170(c); (C) following termination of the payments described in Section 664(d)(2)(A), the remainder interest in the trust is to be transferred to, or for the use of, an organization described in Section 170(c) or is to be retained by the trust for such a use or, to the extent the remainder interest is in qualified employer securities (as defined in Section 664(g)(4)), all or a part of such securities are to be transferred to an employee stock ownership plan (as defined in Section 4975(e)(7)) in a qualified gratuitous transfer (as defined in Section 664(g)); and (D) with respect to each contribution of property to the trust, the value (determined under Section 7520) of the remainder interest passing to charity is at least 10 percent of the initial net fair market value of all property placed in the trust.

Section 664(d)(3) of the Code provides that notwithstanding the provisions of Section 664(d)(2)(A) and (B), the trust instrument may provide that the trustee shall pay the income beneficiary for any year — (A) the amount of the trust income, if such amount is less than the amount required to be distributed under Section 664(d)(2)(A), and (B) any amount of the trust income which is in excess of the trust amount required to be distributed under Section 664(d)(2)(A), to the extent that (by reason of Section 664(d)(3)(A)) the aggregate of the amounts paid in prior years was less than the aggregate of such required amounts.

Section 1.664-3(a)(4) of the Income Tax Regulations (“Regulations”) provides, in part, that a charitable remainder trust may not be subject to a power to invade, alter, amend, or revoke for the beneficial use of a person other than an organization described in Section 170(c).

In Commissioner v. Estate of Bosch, 387 U.S. 456 (1967), the Court considered whether a state trial court's characterization of property rights conclusively binds a federal court or agency in a federal estate tax controversy. The Court concluded that the decision of a state trial court as to an underlying issue of state law should not be controlling when applied to a federal statute. Rather, the highest court of the state is the best authority on the underlying substantive rule of state law to be applied in the federal matter. If there is no decision by that court, then the federal authority must apply what it finds to be state law after giving “proper regard” to the state trial court's determination and to relevant rulings of other courts of the state. In this respect, the federal agency may be said, in effect, to be sitting as a state court.

Issue 2:

Section 4941(a)(1) of the Code imposes an excise tax on disqualified persons for each act of self-dealing between a disqualified person, as defined in section 4946, and a private foundation.

Section 4941(d)(1)(E) of the Code defines self-dealing as including any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

Section 4946(a)(1) of the Code provides that the term “disqualified person” with respect to a private foundation includes a person who is a substantial contributor to the foundation (including the creator of a trust), a family member of a substantial contributor (including children), and a foundation manager (including a trustee).

Section 4947(a)(2) of the Code provides, in pertinent part, that in the case of a trust which is not exempt from tax under section 501(a), not all of the unexpired interests of which are devoted to charitable purposes, and which has amounts in trust for which a charitable deduction was allowed, section 4941 and other provisions apply as if such trust were a private foundation.

Section 4947(a)(2) (A) of the Code provides, in pertinent part, that the provisions of section 4947(a)(2) do not apply with respect to the amounts payable under the terms of such split-interest trust to its income beneficiaries.

Sections 53.4947-1(c)(2) and 53.4947-1(c)(2)(ii), Example (1), of the Foundation and Similar Excise Tax Regulations (“Foundation Regulations”) indicate, in pertinent part, that the payments of income under the term of the trust by a charitable remainder unitrust to its individual income beneficiaries do not result in any tax on self-dealing under Section 4941.

ANALYSIS:

Issue 1:

A modification or reformation of a charitable remainder trust does not violate Section 664 of the Code if the modification or reformation is necessary to conform the trust instrument to the grantor’s intent. In this case, an examination of the trust instrument and the other evidence presented indicates that the provisions of the Trust, as originally drafted, are contrary to the intent of Settlor.

Based on an analysis of the facts submitted and representations made, we have determined that the state court’s reformation of the Trust is consistent with applicable state law, as it would be applied by the highest court of the state. We therefore conclude that the judicial reformation of Trust does not violate Section 664 of the Code. Further, the judicial reformation of Trust will not adversely affect Trust’s qualification as a valid CRUT under Section 664.

Issue 2:

As a charitable remainder unitrust under Section 664(d)(2) of the Code, Trust is a split-interest trust described in Section 4947(a)(2). By being described in Section 4947(a)(2), Trust is subject to the provisions of Section 4941 and certain other provisions, as if it were a private foundation. A private foundation is subject to Section 4941, which imposes an excise tax on acts of self-dealing. Settlers are disqualified persons with respect to Trust because they are substantial contributors to Trust. The income beneficiaries are disqualified persons because they are the Settlers of the Trust. Therefore, because the proposed judicial reformation of the Trust based on a drafting error may have the effect of increasing the annual amount payable to the Settlers, any such increase could be considered to be a transfer to, or use by, or for the benefit of, a disqualified person of income or assets of a private foundation and may be considered to be an act of self-dealing under section 4941.

However, under section 4947(a)(2)(A) of the Code, the self-dealing rules of section 4941 do not apply to any amounts payable under the terms of a split-interest trust to income beneficiaries as long as no deduction was allowed for such income interest under section 170(f)(2)(B), 2055(e)(2)(B), or 2522(e)(2)(B) with respect to the income interest of any such beneficiary. The Settlers have submitted an affidavit stating that that no deduction, under the above Code sections, was taken by the Settlers with respect to any amounts of income payable to them by the Trust. As a result, the self-dealing rules of section 4941 do not apply to the Settlers as income beneficiaries.

Regarding whether the Settlers as substantial contributors are subject to the self-dealing rules of Section 4941 of the Code, the circumstances presented above indicate that there is no act of self-dealing, since we are satisfied that the signatory parties to the Trust never intended to have the provisions of the NIMCRUT continue after the specified Trust property was sold. Certain facts are indicative of this intent, such as the fact that notes in the handwriting of the drafting attorney, who is now incapacitated, indicate that the Trust was supposed to be a CRUT instead of a NIMCRUT after the property was sold. In addition, the Settlers have submitted an affidavit representing that there was a drafting error and that they never intended to have the NIMCRUT continue after the property was sold, and that they intended the Trust to be a CRUT after the property was sold.

RULINGS:

1. The October 1, 2008, judicial reformation of and amendment to the Trust, ab initio, do not violate Section 664 of the Code and the reformed and amended Trust will not adversely affect Trust's qualification as a valid charitable remainder unitrust under Section 664.
2. The proposed judicial reformation of the Trust will not be an act of self-dealing under section 4941 of the Code

This ruling is conditioned on the understanding that there will be no material changes in the facts upon which it is based. This ruling is limited to the issues discussed above. It

does not extend to an examination and approval of Trust under all the requirements of section 664, but only to the impact of a judicial reformation on its qualification as a CRUT. This ruling does not cover any other issue or statute, whether or not discussed in the instant ruling request.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, Notice of Intention to Disclose. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

Because this letter could help resolve any future questions about tax consequences of your activities, you should keep a copy of this ruling in your permanent records.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter. In accordance with the Power of Attorney and Declaration of Representative currently on file with the Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Ronald J. Shoemaker
Manager Technical Group 2

Enclosure:

Notice 437